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RECENT DEVELOPMENTS
IN OIL AND GAS LAW
IN ARKANSAS

Thomas A. Daily

RECENT DEVELOPMENTS IN NATURAL RESOURCES LAW CIRCA 2005

By Thomas A. Daily¹

THE MIDDLE ATOKA INCREASED DENSITY PLAN BECOMES CLEAR FORGET ABOUT UNIT SUBDIVISIONS

In 2002, the Arkansas Oil and Gas Commission issued a couple of landmark orders recognizing that some Arkoma Basin gas wells are incapable of draining their 640 acre units. Those orders mostly involved gas fields on the south flank of the Arkoma which are underlain by discontinuous and thrust-busted middle Atokan sand packages. The 2002 solution, to which this author contributed, was to divide the existing 640 acre units into "unit subdivisions,"² and to permit wells in each such unit subdivision, notwithstanding that reservoir separation could not be established between wells in adjoining subdivisions.

The reason for that approach lay in the Arkansas statute in effect at that time.³ That statute defined a "Unit" as the largest area which could be efficiently and economically drained by a single well. The solution was imperfect. Each unit subdivision arrived with its own well location offset requirement. Thus, it quickly became apparent that more acres were off limits for drilling than were on. Moreover, since the existing wells were located without regard to the new grids imposed by the subdivisions, many of them tended to crowd the legal locations within the new subdivision boxes.

The fix was in the 2003 Arkansas Legislature. Act 276 of 2003 amended the prior statute to delete the reference to drainage area in the definition of unit. Rather, that statute now empowers the Commission to create units, to determine the appropriate number of

¹Member, Daily & Woods, P.L.L.C., Fort Smith, Arkansas.

²160 or 80 acres in area.

³A.C.A. §15-72-303.

wells within a unit and to regulate the spacing of those wells.

With that new statutory flexibility came a better solution. Forget the boxes-within-the-boxes. Instead, simply prescribe a minimum distance between those wells within a unit which produce from a common source of supply.⁴

Expect more gas fields, particularly on the south flank of the Arkoma, to adopt rules of this nature. Also expect additional reservoirs, particularly Upper Atokan, and shales, to be added.

ARKANSAS COURT DISSOLVES INJUNCTION RESTRAINING SURFACE RESTORATION PENDENT LITE

A group of surface owners sued virtually every oil company which had ever owned interests in the wells on their lands, alleging surface contamination. The defendants quickly sought to enter the land and restore the surface, including plugging wells and closing pits. The surface owners refused them access. The circuit judge in the case then issued a restraining order, enjoining the restoration "to prevent irreparable harm" (the destruction of evidence.) After several years mired in the litigation, and a couple of unsuccessful efforts to secure a modification of the injunction, the oil companies appealed to the Arkansas Supreme Court, which dissolved the circuit court's restraining order.⁵

There is much to like about the Court's opinion. It states that the surface owner's real entitlement is to have his land restored, not to receive a verdict in a lawsuit. Surface restoration is the strong public policy of the state of Arkansas. Even if the restraining order was justified at the beginning, the Plaintiffs had plenty of time to find and preserve their

⁴That distance has been set at 560 feet in Waveland, Booneville, Chismville and Mansfield Fields and 750 feet in Gragg Field.

⁵*AJ& K Operating Company v. Smith*, 355 Ark. 510, 140 S.W.3d 475 (2003).

evidence.

**ARKANSAS SUPREME COURT HOLDS PRESUMPTION THAT INDEMNIFICATION
AGREEMENT DOES NOT APPLY TO ACTS OR OMISSIONS OF INDEMNIFIED PARTY
IS INAPPLICABLE TO SURFACE RESTORATION LIABILITY**

There is a completely logical presumption that is used in the judicial construction of an indemnification agreement. Unless the agreement provides so explicitly, a party presumed to not be indemnified from his own acts or omissions. However, in a March 2004 decision, the Arkansas Supreme Court held that presumption to be inapplicable to the indemnified party's duty to conduct well site surface restoration.⁶

Chevron sold producing properties to Murphy, which then sold them to Merit Energy. Both of those contracts required the buyers to indemnify the sellers against all claims relating to the wells which were asserted after the sale date. The surface owners sued Merit and others, including Chevron, alleging surface contamination. Chevron then sued Murphy for a declaratory judgement that Murphy was required to indemnify Chevron. Murphy defended that the indemnification agreement did not expressly state in clear and unequivocal terms that Murphy was to indemnify Chevron for liability that Chevron may have caused to the tract. The circuit court ruled for Murphy, relying upon the presumption against an agreement indemnifying a party against his own fault.

The Supreme Court reversed. It held that since the duty to restore surface is implied by law as a duty of the current working interest owner,⁷ it is logical to assume that it was considered and assumed by the purchaser of the lease. The appellate court also

⁶Chevron U.S.A., Inc. v. Murphy Exploration and Production Company, ____ Ark. ____, ____ S.W.3d ____, (2005).

⁷*Bonds v. Sanchez-O'Brien Oil & Gas Co.*, 289 Ark. 582, 715 S.W.2d 444 (1986).

gave Murphy indemnification from Merit.

The court's ruling is pragmatic. There is a strong public policy favoring restoration of well sites. The current operator is there, on-site, presumably reaping benefits from the well. Placing the primary liability on the current operator is thus more likely to result in the restoration taking place.

**ARKANSAS SUPREME COURT APPLIES ACCRETION
OWNERSHIP RULES TO LEASEHOLD WORKING INTEREST**

*Swaim v. Stephens Production Company*⁸ is an accretion case involving a stretch of the Arkansas River which has emerged as dry land. Pursuant to statute,⁹ the state quit-claimed the emerged lands to the appurtenant riparian owners, including Swaim.

The State's riverbed lease called for a 1/8 royalty. Swaim's lease had been amended to increase his royalty to 3/16. The question presented was one which all parties acknowledged had never been answered in a reported decision: which of those leases applies to the emerged land. Clearly the only question presented was one of law. Both parties moved for summary judgment. The Circuit Court agreed with the lessee, Stephens, that the state lease, with its 1/8 royalty, continued to apply to the former riverbed. The Supreme Court reversed, granting summary judgment, and an extra 1/16 royalty, to Swaim.

The dilemma presented to working interest owners is that under the court's ruling, ownership of existing wells can change with accretion, even to the extent of putting an owner in the well, who was formerly a working interest owner or unleased mineral owner

⁸ ___ Ark. ___, ___ S.W.3d ___ (2004).

⁹A.C.A. §22-5-404.

in an adjoining unit.

In defense of the opinion there is no perfect way to deal with accretions. This is just another example of that. Luckily the Corps of Engineers has pretty much stabilized the Arkansas River, so this kind of case is not likely to often reoccur.

**YOUR HUMBLE AUTHOR IS ALARMED BY LOOSE
LANGUAGE IN OTHERWISE MUNDANE CASE**

*Rigsby v. Rigsby*¹⁰ is, for the most part, a very ordinary estoppel case. It involved a father, Harold Rigsby, and his Son, Brett Rigsby. Brett convinced the circuit court that he had relied to his detriment upon Harold's promise to give him a one-half interest (in partnership) in Harold's farm for working there and contributing to payment of the mortgage debt. The circuit court included a one-half interest in the oil and gas under the property in computing Brett's share.

Harold had argued that there was no evidence of estoppel with regard to the mineral interest. Moreover, he advanced a rather unique "severance" theory. He contended that the combination of his earlier oil and gas lease of the land to Hogback Exploration Company, and the payment of substantial royalties by Hogback to Harold had "severed" the mineral interest from the surface and, thus, Brett did not acquire any mineral interest by virtue of the estoppel.

Sadly, the four members of the court who joined in the majority opinion did not reject that "severance" theory. Rather, the majority ruled that the trial court had not ruled upon the theory and it thus was not properly presented for appeal. Even more remarkable, and

¹⁰ ____ Ark. ____, ____ S.W.3d ____ (2004).

pretty disturbing, is the fact that the three dissenting justices¹¹ would have ruled that the lease and payment of royalties effected a "severance" of the minerals.

Does that mean that these justices would rule that some other conveyance of lands which are subject to a royalty-paying lease and which fails to mention minerals conveys only surface? This author hopes not, but is a little concerned.

**FIFTH CIRCUIT HOLDS THAT REASONABLE POST-PRODUCTION
COSTS ARE PROPORTIONATELY DEDUCTIBLE FROM ROYALTY
IN TEXAS, EVEN WHEN CONTRACT IS WITH AN AFFILIATE**

In 1997, an operator, MC Panhandle, entered into a gas sales agreement with MidCon Gas Services, a subsidiary of MC Panhandle. Both were then subsidiaries of Occidental. Shortly thereafter, Occidental reorganized those companies so that, while they remained affiliated entities, MidCon was no longer a subsidiary of MC Panhandle. Effective March 3, 1998, Chesapeake purchased MC Panhandle. Chesapeake did not buy MidCon.

In April 1998, MidCon began deducting gathering and transportation fees, pursuant to a provision in the 1977 contract (which apparently was not enforced when the seller was its parent company.) Chesapeake passed a proportionate share of those fees through to the royalty owners who sued, contending that the deductions breached their leases. The District Court for the Northern District of Texas granted summary judgment for the royalty owners. It ruled that, because the gas sales agreement was originally entered into by affiliates, which, at the time, had identical management and ownership, it was a sham transaction, as a matter of law.

¹¹Justice Corbin wrote the dissenting opinion and was joined by Justices Brown and Thornton.

The Court of Appeals for the 5th Circuit reversed.¹² The mere fact that contracting parties are affiliates does not establish that the contract is a sham. Rather, the contract's terms should be compared to terms in similar agreements between arm's-length parties to determine whether it is a reasonable agreement.

**THREE RECENT REPORTED CASES APPLY *DAUBERT* TEST
TO "EXPERT" TESTIMONY IN OIL AND GAS CASES**

In his excellent article prepared for the 2001 Arkansas Natural Resources Law Institute,¹³ E. R. Norwood provided us with an excellent discussion of the United States Supreme Court's decision in the case of *Daubert and Kumho Tire Co., Ltd v. Patrick Carmichael et. al.*¹⁴ That case requires the trial court to serve as a gatekeeper for determining the admissibility of expert testimony in civil cases by determining whether the testimony is relevant and has a reliable basis in the witness's knowledge and experience in the relevant discipline. Three 2004 cases, from Oklahoma, Texas and Louisiana, make it clear that state courts will apply the *Daubert* test to alleged oil and gas experts.

**OKLAHOMA APPEALS COURT RULES THAT THE RIGHT TO
INFLATION-ADJUST OVERHEAD RATES IS LOST IF NOT EXERCISED—
PERMITS AN "EXPERIENCED OPERATOR" TO TESTIFY AS
EXPERT ON INDUSTRY CUSTOM UNDER *DAUBERT* STANDARD**

Oneok Resources Company was the operator of several unit wells pursuant to an AAPL JOA and attached COPAS. The COPAS permits the monthly per-well overhead rate to be increased, annually in April, based upon increases in a government index tied

¹²*Ramming v. Natural Gas Pipeline Company of America*, ____ F.3d ____ (5th Cir. 2004).

¹³**EXPERT TESTIMONY - GEOLOGY AND RESERVOIR ENGINEERING: AT TRIAL AND ADMINISTRATIVE HEARINGS.**

¹⁴526 U.S. 137, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999).

to earnings of oil and gas field production workers. However, Oneok and its predecessor operator did not increase these overhead rates for several years. When Oneok realized this it sought to increase the rates to a level which would be attained if all previous increases had occurred. The non-operators sued, contending that Oneok could only increase the overhead rates in comparison the those rates in effect immediately prior to the increase.

The trial court permitted the non-operators to call a witness named Agee. Agee had a Ph.D. in economics but was not a member of COPAS, nor was he an accountant or auditor. Rather, he was an operator of wells and the founder of XAE Corporation. He testified that industry custom followed the non-operators' interpretation of the admittedly ambiguous COPAS provision.

On appeal Oneok challenge the trial court's refusal to sustain a *Daubert* challenge to Agee's expert witness qualifications. Applying what it said was the *Daubert* standard, the Appeals Court held that Agee was entitled to express his opinions upon industry customs and practices.¹⁵

**TEXAS SUPREME COURT, APPLYING *DAUBERT*, REVERSES VERDICT
BECAUSE PETROLEUM ENGINEER WITNESS WAS PERMITTED TO EXPRESS
CONCLUSION AS TO DRAINAGE DAMAGES WITHOUT ADEQUATE FOUNDATION**

In an "implied covenant to prevent drainage"¹⁶ case the royalty owner plaintiffs were allowed to present the testimony of a petroleum engineer named Michael Riley. Riley constructed an economic model which assumed, without any scientific foundation that a

¹⁵*Stephenson v. Oneok Resources Company*, 2004 Ok. Civ. App. 81, ___ P.3d ___, (2004).

¹⁶*Kerr-McGee Corporation, et. al. v. Helton*, 133 S.W.3d 245 (Tex. 2004)

hypothetical well, "timely" drilled upon the Plaintiffs' tract would have produced at exactly the same rates as the alleged draining wells during the time period in question. The Texas Supreme Court reversed a substantial jury verdict for the Plaintiffs by disallowing Riley's testimony as failing to meet the *Daubert*¹⁷ standard. The court agreed that engineering testimony can be used to create a model of the reservoir and predict the performance of a hypothetical well. Indeed, that is what petroleum engineers do. However, that is not what Riley did in this case. He merely assumed, without scientific basis, some hypothetical production volumes which he then multiplied by dollars to reach a damage opinion supportive of the Plaintiffs.

**LOUISIANA COURT OF APPEAL APPLIES *DAUBERT*—ALLOWS "INDUSTRY
EXPERT" TO TESTIFY AS TO DAMAGES FOR FAILURE TO RELEASE LEASE**

A third jurisdiction to apply *Daubert*¹⁸ in an oil and gas case was Louisiana. *Chesapeake Operating Inc. v. Richardson*¹⁹ was a case in which the lessee, Chesapeake, failed to timely exercise its option to extend the primary term of Richardson's lease and then refused to release the lease. Instead, Chesapeake sued for a declaratory judgment that it should be forgiven its untimely exercise of the renewal option because it was the result of "good faith mistake", "inadvertence and oversight." The facts were proven by Richardson to be otherwise. Richardson proved that Chesapeake failed to renew his lease because it was waiting and watching development in the area, before deciding what leases

¹⁷*Supra.*

¹⁸*Supra.*

¹⁹ ___ So. ___, ___ (2004).

to renew.

Chesapeake successfully challenged Richardson's expert witness, Guy Ellison, an "expert in oil and gas leasing in the Austin Chalk trend," on the basis of *Daubert*. On appeal the Louisiana Third Circuit Court of Appeal reversed. That court held that Ellison should have been allowed to testify that there was demand for leases in the vicinity on the day that the primary lease term expired, and that subsequent unsuccessful drilling operations caused that demand to evaporate before Chesapeake actually released Richardson's lease. The appeal court rejected Chesapeake's contention that Richardson was required to prove that he missed an actual, specific opportunity to lease.

**OKLAHOMA SUPREME COURT DISTINGUISHES BETWEEN THEORIES OF
IMPLIED COVENANT TO MARKET AND CESSATION OF PRODUCTION IN PAYING
QUANTITIES—LESSOR'S DEMAND NOT REQUIRED IN THE LATTER TYPE OF CASE**

In *Smith v. Marshall Oil Corporation*²⁰ Smith, the former operator sought to quiet title to certain wells which he had operated as well as equipment left on site. Marshall had obtained new leases from Smith's Lessor. Smith contended that Marshall and the lessor were barred from suing for cancellation of the leases since there had never been demand made for Smith to comply with the implied covenant to market oil or gas from the wells. However, the court was unimpressed with Smith's argument, holding, instead, that the wells had failed to produce in paying quantities and, thus, no demand was required.

Marshall contended that the wells were incapable of producing in paying quantities until Marshall took over and reworked the wells. Smith claimed otherwise but the trial court held, as a matter of fact, for Marshall on that issue. It was undisputed that the revenue from the wells was far less than operating expenses. However, Oklahoma law does permit

²⁰84 P.3d 830 (Ok. 2004).

a lease to continue, although production is at a loss, for "equitable considerations." The Supreme Court found Smith to be devoid of those. Indeed, the court termed Smith's admitted behavior: "I produced them when I felt like producing them. And I turned them off when I felt like turning them off", "conduct...unacceptable for an operator in the state of Oklahoma."

**TEXAS COURT OF APPEALS ENFORCES MAINTENANCE OF UNIFORM INTEREST
CLAUSE—HOLDS WELL PROPOSAL BY FARM-OUTEE INVALID AND HOLDS FARM-OUTOR
LIABLE FOR NON-CONSENT PENALTY**

For years, industry professionals in the Arkoma Basin have given and gotten borehole farm-out agreements, notwithstanding that such agreements are in direct violation of the "Maintenance of Uniform Interest" provision of most JOA's. We have heard various theories why that was not a problem. One of those was that the clause was not specifically enforceable and thus, other parties to the JOA would have to prove damage from its violation. That is precisely what happened in a recent Texas Appeals Court case, *Exxon Mobil Corporation v. Valence Operating Company*.²¹ In that case Texas' First District Court of Appeals affirmed a trial court's award of damages equal to the non-consent penalties which Valence suffered when it ignored well proposals made by Exxon Mobil's farm-outee.

It seems a little disingenuous to conclude that the Farm-outee's well proposals were invalid and, at the same time to charge anyone with the non-consent penalties resulting from those invalid proposals, but that is what appears to have happened. Also, can we just assume that the wells drilled under the illegal farm-outs will ever be good enough to recover those penalties? The case does not appear to be well reasoned at all, regardless

²¹ ___ P.3d ___ (Tex. App. 2004).

of how you feel about Maintenance of Uniform Interest.

This marks the second recent case out of a major oil and gas producing jurisdiction honoring the Maintenance of Uniform Interest provision²² and, if upheld, invites a pretty frightening method for enforcing the clause with damages. Exxon Mobil has petitioned for rehearing. Ultimately, the case may well go to the Texas Supreme Court. We will continue to watch it. Stay tuned.

IT'S ANOTHER ONE OF THEM ODD YEARS, ZEEK, THE LEGISLATURE'S ON THE LOOSE

In Arkansas, "odd" years are made a bit odder by the biannual phenomenon known as the "Regular Session of the General Assembly." Picture citizen legislators from the hills and swamps descending upon the state capital, each with a mission: to fix, by hook or crook, every perceived injustice done recently to any of their constituents and, in the process, advance the combined agendas of the NRA, MADD and last Sunday's fire and brimstone sermon at Third Reformed Antioch Pentecostal Free Will. It usually is a pretty scary sight, and 2005 will be no exception, although the follies have just begun.

Here are the texts of bills introduced or under consideration for introduction as of February 15. These have been ranked according to the standard system as **Good, Maybe Good, Bad and Absolutely Awful**. Things change instantly in the Legislature. Therefore, our oral presentation may or may not vaguely resemble these bills. Nevertheless, here goes:

²²The other being *Pitco v. Chaparral*, 2003 Ok. 5, 63 P.3d 531 (2003).

Stricken language would be deleted from and underlined language would be added to the law as it existed prior to this session of the General Assembly.

1 State of Arkansas

2 85th General Assembly

3 Regular Session, 2005

A Bill

HOUSE BILL 1224

5 By: Representative Maloch

6 By: Senators Horn, G. Jeffress

For An Act To Be Entitled

10 AN ACT TO AMEND § 15-72-102 TO DEFINE OPERATOR;
11 TO AMEND § 15-72-303 TO ALLOW AN OPERATOR TO
12 APPLY FOR AN ORDER TO INTEGRATE THE INTERESTS OF
13 OWNERS IN A DRILLING UNIT; AND FOR OTHER
14 PURPOSES.

Subtitle

17 AN ACT TO DEFINE OPERATOR AND TO ALLOW
18 AN OPERATOR TO APPLY FOR AN ORDER TO
19 INTEGRATE THE INTERESTS OF OWNERS IN A
20 DRILLING UNIT.

23 BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF ARKANSAS:

25 SECTION 1. Arkansas Code § 15-72-102 is amended to read as follows:
26 15-72-102. Definitions.

27 As used in this act, unless the context otherwise requires:

28 (1) "Commission" means the Oil and Gas Commission as created by
29 this act;

30 (2) "Person" means any natural person, corporation, association,
31 partnership, receiver, trustee, guardian, executor, administrator, fiduciary,
32 federal agency, or representative of any kind;

33 (3) "Oil" means crude petroleum oil, and other hydrocarbons,
34 regardless of gravity, which are produced at the well in liquid form by
35 ordinary production methods and which are not the result of condensation of
36 gas after it leaves the reservoir;

